King County

OFFICE OF ECONOMIC AND FINANCIAL ANALYSIS

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March 10, 2010

Honorable Members of the Forecast Council:

We are pleased and honored to transmit the preliminary forecasts for the "Pre-Status-Quo" phase of the 2011 King County budget. This is the first set of forecasts compiled by the newly created Office of Economic and Financial Analysis. Fiscal 2011 will be a year of continuing economic recovery in King County, producing a mixed outlook for revenues.

This document is organized by revenue topic. Each section provides the economic context of the outlook for the revenue stream along with 'at-a-glance' tables with previous years' history and projections out to five years. A briefing on the methodology we have developed precedes this. Attached as an appendix are detailed tables of all revenue and inflation forecasts in PDF format. A separate file in Excel format is also included.

This document is a revised version of the March 1, 2010 transmittal. Since that time we have had consultations with staff of the Forecast Council, Finance and Business Operations, and the Department of Transportation. The new information has led us to revising the following forecasts:

- **Sales tax revenues**
- **Investment pool returns**
- **Price of diesel fuel**

All other forecasts remain as before.

We look forward to working with you in the coming days.

Tom Goodwin, PhD
Chief Economist

Tony Cacallori
Economist

PRELIMINARY ECONOMIC AND REVENUE FORECASTS FOR THE KING COUNTY BUDGET: 2011 AND BEYOND

Office of Economic & Financial Analysis
March 8, 2010

The Economic Context

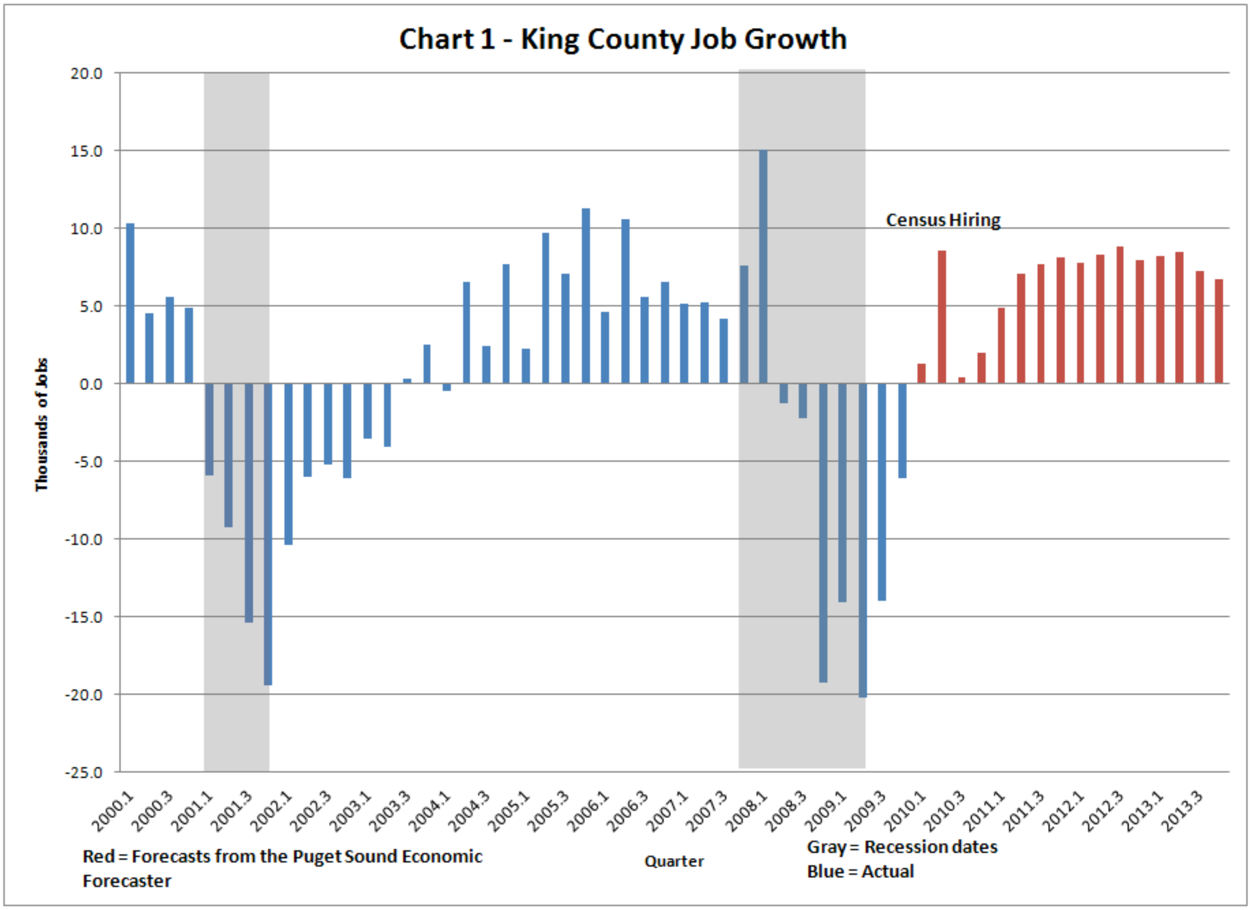
It is important to have a perspective on the economy at the national level before drilling down to the county level. The National Bureau of Economic Research will most likely date the Great Recession as officially ending at the end of last summer. Keep in mind that a recession refers to a period of *diminishing* economic activity, not *diminished.* So when the economy hits bottom the recession is technically over, but diminished economic activity can persist for some time as we are seeing.

Big banks and residential real estate have dominated the headlines over the past two years. Look for global government debt, regional banks and commercial real estate to dominate concerns over the next two years. They will be major speed bumps to the recovery that is under way, but not enough to stop the recovery in our view. A double-dip recession is unlikely.

The forecasts will be in terms of dollars and percents; it is instructive to also look at the picture in more human terms, namely jobs gained and lost. There is some unpleasant arithmetic across the nation. It is estimated that there are 18 million people unemployed in the US, either actively looking for work or too discouraged to look anymore. Once the economy is fully up to speed it will generate between 200,000 and 300,000 new jobs per month. That means it will take 5 to 7½ years of good growth for all of those people to find jobs, and that does not take into account new entrants into the labor market. We can see that long-term unemployment will be a major social and economic problem in the coming years.

Turning to King County, the job picture is serious but not as dire as in many other parts of the country, thanks to our relatively stable employment in the software and aerospace industries. As Chart 1 shows, King County was late in being affected by the recession, but still has shed more than 75,000 jobs since the middle of 2008. The good news is that 2010 will see the county return to positive employment growth. Hiring for the census will provide an immediate boost. However, it will be to the end of 2012 or beginning of 2013 before all the lost jobs are made back.

The overall revenue outlook for the County parallels the job picture. The years 2010 and 2011 will be recovery years. Full recovery to pre-recession levels will not occur until 2012 at the earliest and more likely a year or two after that.



The Forecasting Methodology

Our modeling process has two stages in order to incorporate both the state of the economy and revenue-specific information. In the first stage, revenues and inflators that are required for the King County budget process are linked by dynamic regression to national, state and local economic variables. The second stage is where we make adjustments to revenues based on assumptions regarding potential annexations, population weights, mitigation payments, etc. The specific adjustments are detailed in the forecasting tables.

Data history and projections of the economic variables are gathered from a wide array of sources. They are listed below in Table 1.

Table 1	*Coverage*	*Projections*
IHS Global Insight	National	Baseline, optimistic, pessimistic
Blue Chip Consensus Forecasts	National	Mean, highest 10, lowest 10
State Economic & Revenue Forecast Council	National, Washington State	Baseline, optimistic, pessimistic
Puget Sound Economic Forecaster	National, Puget Sound, King County	Most likely

We construct median, high and low forecasts by blending the projections from these sources and linking them to county revenues and inflators. The assumptions behind the revenue and inflator forecasts reflect the consensus of a diverse group of professional forecasters, the range of their disagreement, and the judgment of the chief economist. This provides us with a confidence range of forecasts that is based on the best available expertise. In our view, this is more informative than if we were to assume a theoretical distribution such as a normal bell curve for a confidence range. The definitions of the forecasts are contained in Table 2.

Our methodology is similar in some ways to that of the state Economic & Revenue Forecast Council (ERFC). Both methodologies use IHS Global Insight and Blue Chip Consensus Forecasts for example. But we use the ERFC forecasts as inputs as well. And there will inevitably be some differences in judgment between the chief economists of the state and the county.

Table 2	*Definition*
Median Forecast	Actual value is equally likely to be higher or lower than the forecast (50/50).
Low Forecast	10% probability that the actual value will be equal or lower, 90% that it will be higher
High Forecast	10% probability that the actual value will be equal or higher, 90% that it will be lower.
High – Low Forecast	80% probability that the actual value will fall within this confidence range.

Property Taxes: Assessed Valuation and New Construction

The property picture is a tale of two sectors – residential and commercial. The outlook for the residential sector is complicated, with signs of life and renewal combined with continuing difficulties. Single-family house prices in the county appear to have bottomed out and are beginning to creep up again. Building permits for single-family houses in the county are up, albeit from a very depressed level. The Homebuyer's Tax Credit has had a positive effect, but the second round does not appear to have led to an increase in mortgage applications. And foreclosures continue as long-term unemployment replaces sub-prime mortgages as the main cause.

Multi-family housing is in a difficult position. We are seeing a reversal of past condo conversion trends: now condos are being "collapsed" back into rental apartments. This usually results in reduced assessed valuations, especially with the current downward pressure on rents.

There is nothing complicated about the outlook for the commercial sector: it's grim. Tax Assessor Lloyd Hara reports that there were 8.2 million square feet of unoccupied office space in Seattle alone at the end of 2009. Ten Class A rated office buildings had no tenants at all. This glut will affect new construction for years to come. It will also drive down assessed valuations as income is one of the key inputs the assessors use to set values on commercial properties.

For all sectors the Assessor's Office relied on smoothing valuations over 3-4 years to capture the underlying trends before the recession. This made sense when valuations only went up. But the recent turmoil in real property led the then-Assessor to put a heavier weight on the most recent data, resulting in an unprecedented fall in aggregate assessed valuations of almost 12%. Will that downward trend continue? Given the situation in the commercial sector and multi-family housing, and the timing of valuations – valuations as of January 1, 2010 are applied to tax year 2011 - we think it most likely that there will be one or two more years of aggregate assessed value reductions, though not as severe as last year's.

All of the leading indicators for new construction point to a modest turn-around. Those indicators include construction employment, building permits, house prices and GDP growth. But since new construction is only billed by the Assessor's Office when completed or partially completed, and is then applied to the following year's tax assessments, in our view it is likely that new construction will also suffer another two years of diminishing activity for tax purposes.

King County Assessed Value and New Construction Forecast

	New Construction (in billions $)				Assessed Value (in billions $)		
Tax Year	**Median**	**High**	**Low**		**Median**	**High**	**Low**
2008	6.66	6.66	6.66		341.00	341.00	341.00
2009	8.01	8.01	8.01		386.89	386.89	386.89
2010	5.21	5.21	5.21		341.97	341.97	341.97
2011	3.32	4.26	1.41		322.19	342.83	291.51
2012	3.10	4.23	1.53		309.80	349.67	285.17
2013	3.58	4.81	2.31		322.74	355.85	277.78
2014	4.54	5.57	3.91		338.67	374.97	279.53

Inflation and COLAs

Since the beginning of the financial crisis the Federal Reserve Bank has created over $1 trillion in new money. That's not borrowed money, that's money created out of thin air. This would be highly inflationary in normal times. But these are not normal times, as the Consumer Price Index (CPI) actually declined in 2009.

There is no expectation that a repeat of 2009's deflation will occur. Our view is that there will be a modest snap back of inflation this year as businesses recover their reduced profit margins, but inflation will remain under control for the next few years thereafter. We believe the Fed has the tools necessary to restrain inflation and will use them when the time comes. This applies to both the CPI-U (all urban consumers) and the CPI-W (office workers and wage earners).

The September-to-September CPI-W is the basis for calculating Cost-of-Living-Allowances (COLAs) for most union contracts with the County. The COLA forecasts for September 2010 - which will be applied to the 2011 contracts - are in the likely range of 2.5% to 3.5%. But they drop down to the 2.0% to 3.0% range in 2012 and even less thereafter.

Other prices forecasted are the CPI for Seattle (technically, the CPI-W for Seattle, Tacoma, and Bremerton), the producers' price index for pharmaceuticals, the CPI-U for transportation and the price of diesel fuel. Details are in the attached appendices.

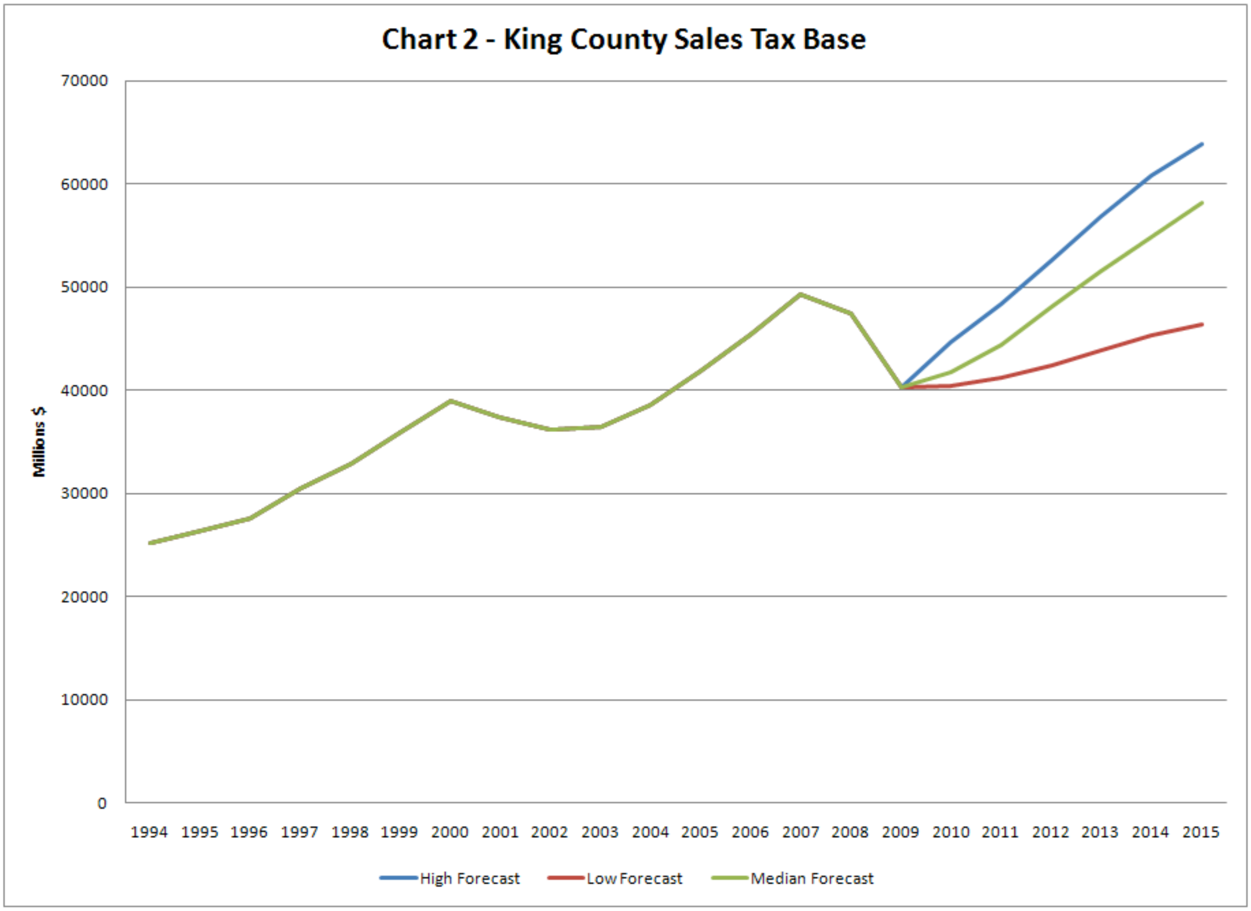
King County COLA Forecast

	Median	High	Low
2006	4.66%	4.66%	4.66%
2007	2.00%	2.00%	2.00%
2008	2.49%	2.49%	2.49%
2009	4.88%	4.88%	4.88%
2010	2.00%	2.00%	2.00%
2011	2.87%	3.54%	2.48%
2012	2.22%	3.00%	2.00%
2013	2.02%	2.66%	2.00%
2014	2.00%	2.32%	2.00%
2015	2.00%	2.22%	2.00%

Sales and Use Taxes

Forecasting sales and use tax revenues presents a special challenge because of the numerous buckets earmarked to particular jurisdictions, geographic areas, and types of business. We use economic variables to forecast the overall sales tax base for King County and then conduct separate analyses to fill each bucket as a draw from the tax base well.

Leading indicators for the tax base are taxable sales, real GDP growth, core inflation (less energy and food), and personal income. The median forecast shown in Chart 2 predicts steady improvement in the sales tax base but it will not regain its 2007 high of $49 billion until 2012 or 2013.



King County Median Sales Tax Forecast

Year	Undesignated General Fund	Children and Family Services	Transit	Criminal Justice	Mental Health
2007	87,684,650	4,227,981	442,042,300	14,229,175	-
2008	83,639,943	4,032,953	432,934,213	12,973,186	35,564,904
2009	72,503,236	3,495,963	375,333,093	11,039,533	41,599,238
2010	78,005,005	3,761,248	389,551,956	11,185,502	43,283,551
2011	79,927,142	3,853,929	407,419,069	10,903,138	45,268,785
2012	84,083,645	4,054,348	431,854,808	10,924,732	47,983,868
2013	88,951,393	4,289,061	455,843,173	11,531,571	50,649,241
2014	92,161,882	4,443,864	471,345,429	11,923,735	52,371,714

King County High Sales Tax Forecast

Year	Undesignated General Fund	Children and Family Services	Transit	Criminal Justice	Mental Health
2007	87,684,650	4,227,981	442,042,300	14,229,175	-
2008	83,639,943	4,032,953	432,934,213	12,973,186	35,564,904
2009	72,503,236	3,495,963	375,333,093	11,039,533	41,599,238
2010	85,751,000	4,134,744	430,240,725	12,353,830	47,804,525
2011	87,386,971	4,213,628	447,084,084	11,964,633	49,676,009
2012	90,667,548	4,371,810	468,820,606	11,859,864	52,091,178
2013	98,007,111	4,725,710	506,771,763	12,819,923	56,307,974
2014	104,796,126	5,053,063	541,876,166	13,707,968	60,208,463

King County Low Sales Tax Forecast

Year	Undesignated General Fund	Children and Family Services	Transit	Criminal Justice	Mental Health
2007	87,684,650	4,227,981	442,042,300	14,229,175	-
2008	83,639,943	4,032,953	432,934,213	12,973,186	35,564,904
2009	72,503,236	3,495,963	375,333,093	11,039,533	41,599,238
2010	74,012,896	3,568,756	362,223,894	10,400,811	40,247,099
2011	71,700,330	3,457,249	366,829,013	9,816,888	40,758,779
2012	73,145,346	3,526,924	378,217,415	9,567,854	42,024,157
2013	75,659,096	3,648,133	391,215,426	9,896,668	43,468,381
2014	78,053,738	3,763,597	403,597,555	10,209,901	44,844,173

Hotel/Motel and Rental Car Taxes

The recession has naturally affected the volume of business travel and tourism in King County. Leading indicators such as GDP growth and personal income indicate a return to pre-recession levels within the relatively short time frame of 2011 to 2012. However, the portion generated in the City of Bellevue will revert to the City beginning in 2013.

King County Rental Car and Hotel Sales Tax Forecast

	Rental Car Sales Tax				Hotel Sales Tax		
	Median	High	Low		Median	High	Low
2007	2,831,983	2,831,983	2,831,983		20,299,205	20,299,205	20,299,205

2008	2,895,014	2,895,014	2,895,014		20,966,727	20,966,727	20,966,727
2009	2,656,720	2,656,720	2,656,720		17,346,819	17,346,819	17,346,819
2010	2,780,520	3,000,418	2,650,354		18,625,897	20,001,247	16,183,534
2011	2,882,620	3,099,417	2,654,907		19,696,423	21,103,294	17,566,675
2012	3,030,114	3,214,302	2,725,413		21,162,948	22,550,681	19,551,006
2013	3,172,326	3,415,951	2,804,945		22,624,269	24,096,389	21,016,088
2014	3,263,239	3,601,621	2,880,336		23,719,172	25,571,717	22,123,041

Real Estate Excise Taxes

REET is essentially a sales tax on real estate transactions. The strongest leading indicators of future transactions are trends in house prices, both at the national and local level, mortgage rates, single family housing construction and housing permits. The improving but mixed picture of the real estate market suggests that in 2010 we could see a modest increase from the depressed levels of 2009, but there is a good deal of uncertainty about that as shown in the wide spread between high and low forecasts. Beginning in 2011 we should see a return to a sustained upward trend.

King County REET 1 Forecast

	Median	High	Low
2005	11,288,087	11,288,087	11,288,087
2006	11,710,069	11,710,069	11,710,069
2007	9,202,858	9,202,858	9,202,858
2008	4,912,082	4,912,082	4,912,082
2009	3,809,800	3,809,800	3,809,800
2010	4,042,732	4,745,036	3,427,248
2011	4,040,582	4,974,783	3,376,168
2012	4,430,397	5,610,159	3,542,086
2013	4,968,323	6,045,101	4,197,544
2014	5,319,223	6,168,915	4,689,363

The Investment Pool Rate of Return

The weighted average maturity in the investment pool hovers around one year and consists mainly of Treasuries and other government issues. The shortness of the pool's maturity means that the Federal Funds Rate will be the most important factor driving the pool's yield and net return.

There is wide agreement that the Fed will raise its rates, but disagreement over when, how fast and how far. The Fed must weigh the consequences of harming the fragile recovery with the chance that the trillion dollars in new cash sloshing around will set off a wave of inflation. Some analysts think the Fed will tighten as early as this summer, others believe the Fed won't dare threaten the recovery until 2012. We have incorporated this uncertainty among the experts into our forecast spread. Our view is that the Fed will begin to ratchet up interest rates in late 2010 or early 2011, gradually raising the Fed Funds rate to the 4 - 4½% range.

We found that the slope of the yield curve is also a good predictor of the pool's return. The slope is the difference between the yield on a long bond such as the 10-year Treasury note and the yield on a short-term instrument such as the 3-month Treasury bill. A steeper slope usually benefits the pool's return.

Other factors that impact the pool's returns are the callable features of some of the instruments in the pool and the timing of cash flows. The low current rates are expected to result in a portion of the pool being called and having to be replaced with lower yielding instruments. Also, the pool expects to receive around $1 billion – about a fifth of the total pool - from the Tax Assessor's office in April; the low current yields will drag down pool's overall return. These factors result in a decrease in the forecast from what they otherwise would be.

The Fed's anticipated moves will lead to an upward trend in pool returns starting in 2011. (Note: these forecasts assume the investment pool does not venture back into the commercial paper market.)

King County Investment Pool Rate of Return Forecast

	Median	High	Low
2005	3.15%	3.15%	3.15%
2006	4.68%	4.68%	4.68%
2007	5.09%	5.09%	5.09%
2008	3.30%	3.30%	3.30%
2009	1.75%	1.75%	1.75%
2010	1.60%	1.84%	1.48%
2011	2.68%	3.07%	2.21%
2012	4.10%	4.82%	3.58%
2013	4.59%	5.50%	3.89%
2014	5.05%	5.93%	4.31%

Summary

Fiscal year 2011 will be a continuation of the ongoing economic recovery in King County, producing a mixed outlook for revenues.

- New construction and assessed valuations will likely continue to decline in 2011.
- Sales tax revenues will likely increase in most categories. Exceptions are those categories most affected by planned annexations, such as Criminal Justice.
- Hotel and rental car sales tax revenues will likely see increases as business travel and tourism pick up.
- Real Estate Excise Taxes will likely be flat compared to 2010.

- The COLA for 2011 labor contracts will likely be close to 3%.
- Other inflators – US and Seattle CPI, diesel fuel prices – will have modest increases. A notable exception is pharmaceuticals, which shows no signs of abating.
- The net rate of return to the investment pool will be negatively impacted by the current low yields but will move up in lock-step with Fed rate increases.